

REPORT OF EXAMINATION  
OF THE  
FARMERS INSURANCE EXCHANGE  
  
AS OF  
DECEMBER 31, 2006

Participating State  
and Zone:

California

Filed June 23, 2008

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Los Angeles, California  
June 23, 2008

Honorable Alfred W. Gross  
Chairman of the NAIC Financial  
Condition Subcommittee  
Commissioner of Insurance  
Virginia Bureau of Insurance  
Richmond, Virginia

Honorable Morris Chavez  
Secretary, **Zone IV-Western**  
Superintendent of Insurance  
New Mexico Insurance Division  
Santa Fe, New Mexico

Honorable Steve Poizner  
Insurance Commissioner  
California Department of Insurance  
Sacramento, California

Dear Chairman, Secretary and Commissioner:

Pursuant to your instructions, an examination was made of the

#### FARMERS INSURANCE EXCHANGE

(hereinafter also referred to as the Exchange) at its home office located at 4680 Wilshire Boulevard, Los Angeles, California 90010.

#### SCOPE OF EXAMINATION

The previous examination of the Exchange was made as of December 31, 2003. This examination covers the period from January 1, 2004 through December 31, 2006. The examination was made pursuant to the National Association of Insurance Commissioners' plan of examination. The examination included a review of the Exchange's practices and procedures, an examination of management records, tests and analyses of detailed transactions, and an evaluation of the assets and a determination of liabilities as of December 31, 2006, as deemed necessary under the circumstances. This examination was conducted concurrently with the Exchange's California subsidiaries and affiliates, namely: Fire Insurance Exchange, Truck Insurance Exchange, Mid-Century Insurance

Company, Civic Property and Casualty Company, Exact Property and Casualty Company, Neighborhood Spirit Property and Casualty Company, and Farmers Reinsurance Company.

In addition to those items specifically commented upon in this report, other phases of the Exchange's operations were reviewed including the following areas that require no further comment: corporate records; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of exchange; business in force by states; loss experience; accounts and records; and sales and advertising.

### SUBSEQUENT EVENTS

#### Bristol West Holdings, Inc.

On July 3, 2007, Farmers Group, Inc. (FGI), the attorney-in-fact for the three exchanges, completed the acquisition of Bristol West Holdings, Inc. (BWH), a Delaware corporation, including its two directly-owned insurance company subsidiaries; Security National Insurance Company, a Florida company, Bristol West Preferred Insurance Company, a Michigan company, and certain insurance services companies. Also included in the acquisition were BWH's directly owned insurance holding company; Coast National Holding Company, a California company, and its insurance company subsidiary Coast National Insurance Company (CNIC), a California company, which in turn owned Bristol West Insurance Company, an Ohio company, and Bristol West Casualty Insurance Company, an Ohio company.

BWH, via its insurance subsidiaries, had licenses in 38 states plus the District of Columbia, operated in 22 states and was a provider of liability and physical damage insurance, specializing in non-standard private passenger auto.

FGI paid \$713.5 million plus the assumption of \$100 million of debt obligations for BWH. Additional consideration for the transaction included the "commutation of certain existing affiliated reinsurance arrangements" between BWH's insurance subsidiaries, and the execution of a 90% quota

share cession agreement between CNIC and the Exchange to be effective January 1, 2007. The CNIC quota share agreement was approved by the California Department of Insurance (CDI) on June 29, 2007.

The Exchange also entered into a similar 90% quota share agreements with BWH's affiliates; Bristol West Insurance Company (Ohio), Bristol West Casualty Insurance Company (Ohio), Bristol West Preferred Insurance Company (Michigan), and Security National Insurance Company (Florida). It is recommended that the Exchange submit these reinsurance agreements with affiliates to the CDI if and when the activity underlying these agreements exceeds the thresholds indicated in California Insurance Code (CIC) Section 1215.5(b)(3).

The above transactions resulted in changes in the ultimate control of BWH's subsidiary, CNIC. The Exchange and Zurich Financial Services (ZFS), a Swiss company and FGI's ultimate parent corporation, filed a joint Form A application pursuant to CIC Section 1215.2. Additionally, Form D applications were filed pursuant to CIC Section 1215.5. On June 28, 2007, the Exchange received correspondence from the CDI that the transactions were "not disapproved".

Concurrent with the acquisition, FGI sold BWH's underlying insurance business to the Exchange, Truck Insurance Exchange (Truck), Fire Insurance Exchange (Fire), and Mid-Century Insurance Company (Mid-Century) for \$420 million, which represented an equity value of \$370 million plus \$50 million of debt assumption. In addition, the Exchange, Truck, Fire, and Mid-Century incurred transaction fees of \$13.8 million. FGI retained certain of BWH's employees, the operational systems, and the management servicing rights. The acquisition was recorded using the statutory purchase method of accounting. The following schedule depicts each exchange/company's share of the costs, fees and goodwill for the acquisition of the BWH insurance business:

(in millions)			
<u>Entity</u>	<u>Cost and Fees</u>	<u>Goodwill</u>	<u>Percentage</u>
Farmers Insurance Exchange	\$162.7	\$38.2	37.50%
Truck Insurance Exchange	38.0	8.9	8.75%
Fire Insurance Exchange	16.3	3.8	3.75%
Mid-Century Insurance Company	<u>216.8</u>	<u>51.0</u>	<u>50.00%</u>
Totals	<u>\$433.8</u>	<u>\$101.9</u>	<u>100.00%</u>

On May 8, 2008, the intermediate-level holding structure was re-organized and FGI is now currently owned 87.9% by Zurich Insurance Company (ZIC), 10.375% by Zurich Group Holdings (ZGH), and 1.725% by three Partnerships (Zurich RegCaPs II, V, VI) having ZIC as the General Partner and ZGH as the Limited Partner. ZFS continues to be the ultimate controlling party.

#### Surplus Loan Note Facility

The Exchange entered into a “Credit Agreement” dated July 10, 2007, arranged by Swiss Reinsurance Company, a Swiss company. Commerzbank International S.A., a Luxembourg company acted as Administrative Agent for certain European lender banks. Pursuant to this credit agreement the lenders committed to purchase Surplus Loan Notes from the Exchange based on a Trigger Event (catastrophic windstorm losses in excess of \$1.5 billion incurred losses in the states of Arkansas, Louisiana, Oklahoma, and/or Texas), at any time and from time to time prior to the commitment termination date of July 10, 2012, in an aggregate principal amount not in excess of \$500 million. The Surplus Loan Notes would be subordinated obligations of the Exchange with a 10 year final maturity and the payment of principal and interest on the surplus loan notes would require the approval of the CDI. The fees paid by the Exchange for the right to access this facility were \$8.9 million through the third quarter 2007.

This credit agreement establishes an advance facility in place to assure the placement of reasonably-priced surplus notes, or certificates of contribution, to re-capitalize the Exchange in the event a catastrophic wind event greater than the layers of reinsurance currently provide.

## EXCHANGE HISTORY

The Exchange was incorporated in California on September 28, 1928, for the purpose of conducting property and casualty insurance.

A significant portion of the Exchange's reported surplus as regards policyholders at the examination date was composed of surplus notes (issued to non-affiliates), and contribution certificates (issued to affiliates). The following schedule depicts the specific issuances and amounts outstanding at December 31, 2006:

<u>Date issued</u>	<u>Interest Rate</u>	<u>Par Value</u>	<u>Maturity Date</u>
05/11/1994	8.625%	\$300,000,000	05/01/2024
07/10/1998	7.050%	373,077,000	07/15/2028
07/10/1998	7.200%	111,923,000	07/15/2048
06/21/2004	6.150%	280,000,000	12/31/2013
08/09/2004	6.000%	100,000,000	08/01/2014
12/23/2004	6.150%	<u>296,000,000</u>	08/01/2014
Total		<u>\$1,461,000,000</u>	

The aforementioned notes and certificates have restrictions, which require the approval of the California Department of Insurance (CDI) before payment of interest and principal. Interest can be paid out of earned (unassigned) surplus only. The payments of interest and repayments of principal, occurring during this examination period were made with the approvals of the CDI.

The surplus notes, transacted in 1994 and 1998, were issued to qualified institutional buyers in the open market and are administered by JP Morgan Chase Bank.

The certificate of contribution in the amount of \$280 million listed above was issued to Zurich Capital Markets, Inc. (ZCM) on June 21, 2004 in consideration for its surrender and discharge of certain certificates originally issued on November 15, 2001, but assigned by Farmers Group, Inc. (FGI) to ZCM on January 30, 2004. On July 28, 2004, the certificate was assigned by ZCM to Zurich Investments LLC, a Luxembourg company.

The surplus notes listed above in the amount of \$100 million were issued on August 9, 2004 to qualified institutional buyers in the open market and are administered by JP Morgan Chase Bank. These notes replace the \$100 million of surplus notes that were issued during 1994 and matured on August 2, 2004.

The certificate of contribution listed above in the amount of \$296 million was issued to Farmers New World Life (FNWL) on December 23, 2004, as part of a refinancing transaction in which the Exchange canceled the certificates originally issued on March 7, 2000. The certificates were transferred to FGI on October 10, 2005, and subsequently transferred to Zurich Group Holdings (ZGH) on November 21, 2005.

On September 28, 2006, Exchange repaid the \$107 million of surplus notes held by ZGH which matured on September 30, 2006.

#### Foremost Corporation of America

In October 1999, Spartan Parent Corporation (Spartan), a jointly-owned subsidiary of the Exchange, Fire Insurance Exchange (Fire) and Truck Insurance Exchange (Truck), entered into an agreement to acquire Foremost Corporation of America (Foremost Corp.) for \$812 million. Foremost Corp. owned Foremost Insurance Company of Grand Rapids, Michigan (Foremost I.C.), which predominately wrote recreational vehicle and mobile home policies. The three exchanges gave notices of the investment to the CDI under California Insurance Code Section 1215.5(b)(1). In March of 2000, the Foremost Corp. acquisition was finalized.



Effective at the time of the acquisition, Spartan was merged with and into Foremost Corp. and its outstanding common stock interest in Foremost Corp. was redistributed to the aforementioned three exchanges. The exchanges accounted for the acquisition using the statutory purchase method of accounting. The Exchange's equity ownership of Foremost Corp. is 80%, with sister exchanges Fire and Truck each owning 10%.

The three exchanges each reported their investments in Foremost Corp. as two separate and distinct investments. The investment in Foremost Corp. was reported at the GAAP equity value plus the remaining goodwill balance (after amortization) less the non-admissible portion of goodwill pursuant to National Association of Insurance Commissioners' Statutory Accounting Principles. The investment in Foremost I.C. was reported at the statutory equity value indicated in the Foremost I.C. Statutory Annual Statement.

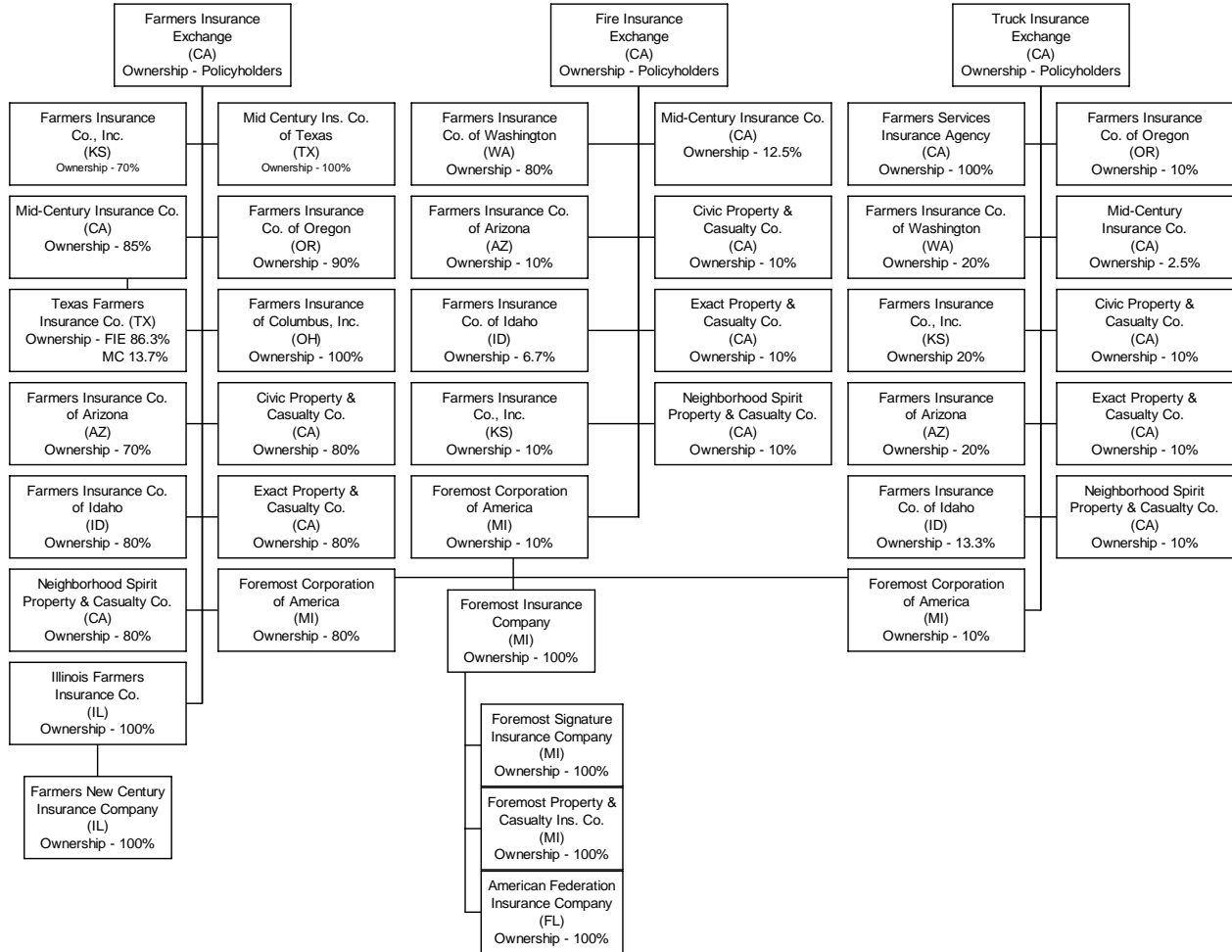
#### MANAGEMENT AND CONTROL

The Exchange, a reciprocal insurer organized under California Insurance Code (CIC) Section 1300 et. seq. is controlled by its attorney-in-fact, Farmers Group, Inc. (FGI), dba Farmers Underwriters Association. FGI is a U.S. subsidiary of Zurich Financial Services, a Swiss holding company.

The following abridged organizational charts show the relationship of the Exchanges to its affiliates as of December 31, 2006, and subsequent to the acquisition of Bristol West Holdings, Inc.:

# FARMERS EXCHANGES

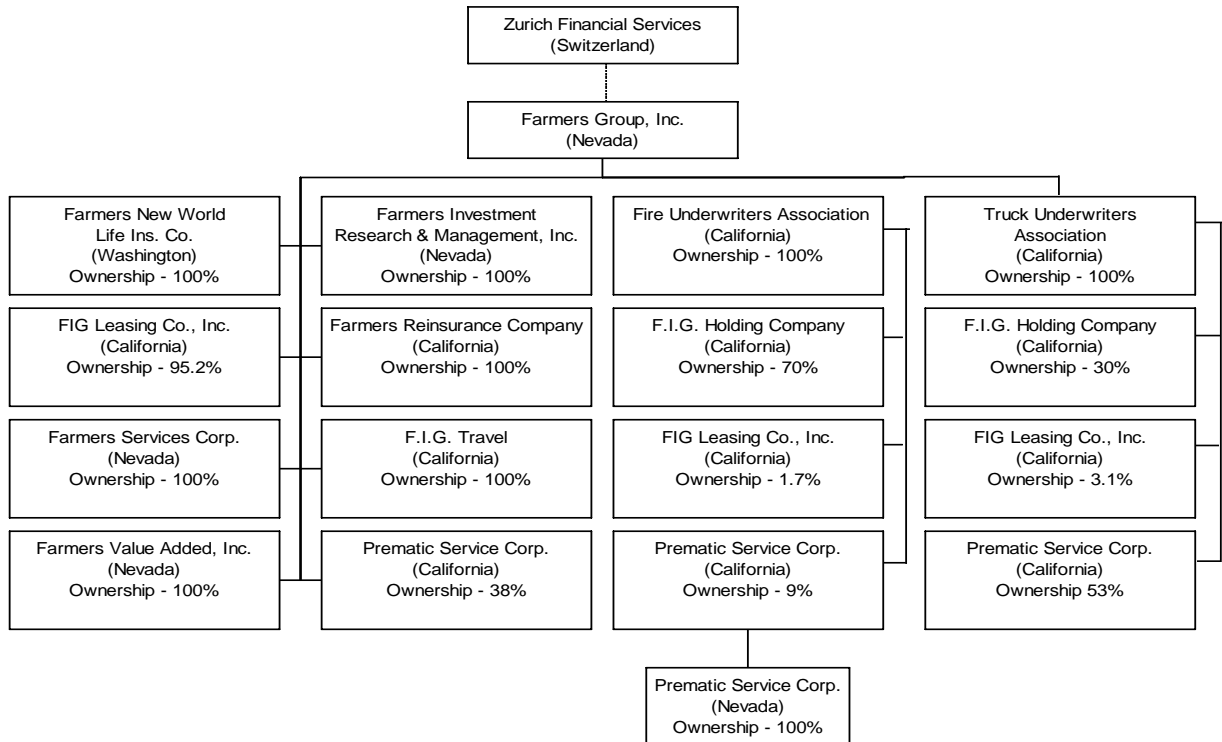
December 31, 2006



(\*) all ownership is 100% unless otherwise noted.

## ZURICH FINANCIAL SERVICES GROUP

December 31, 2006

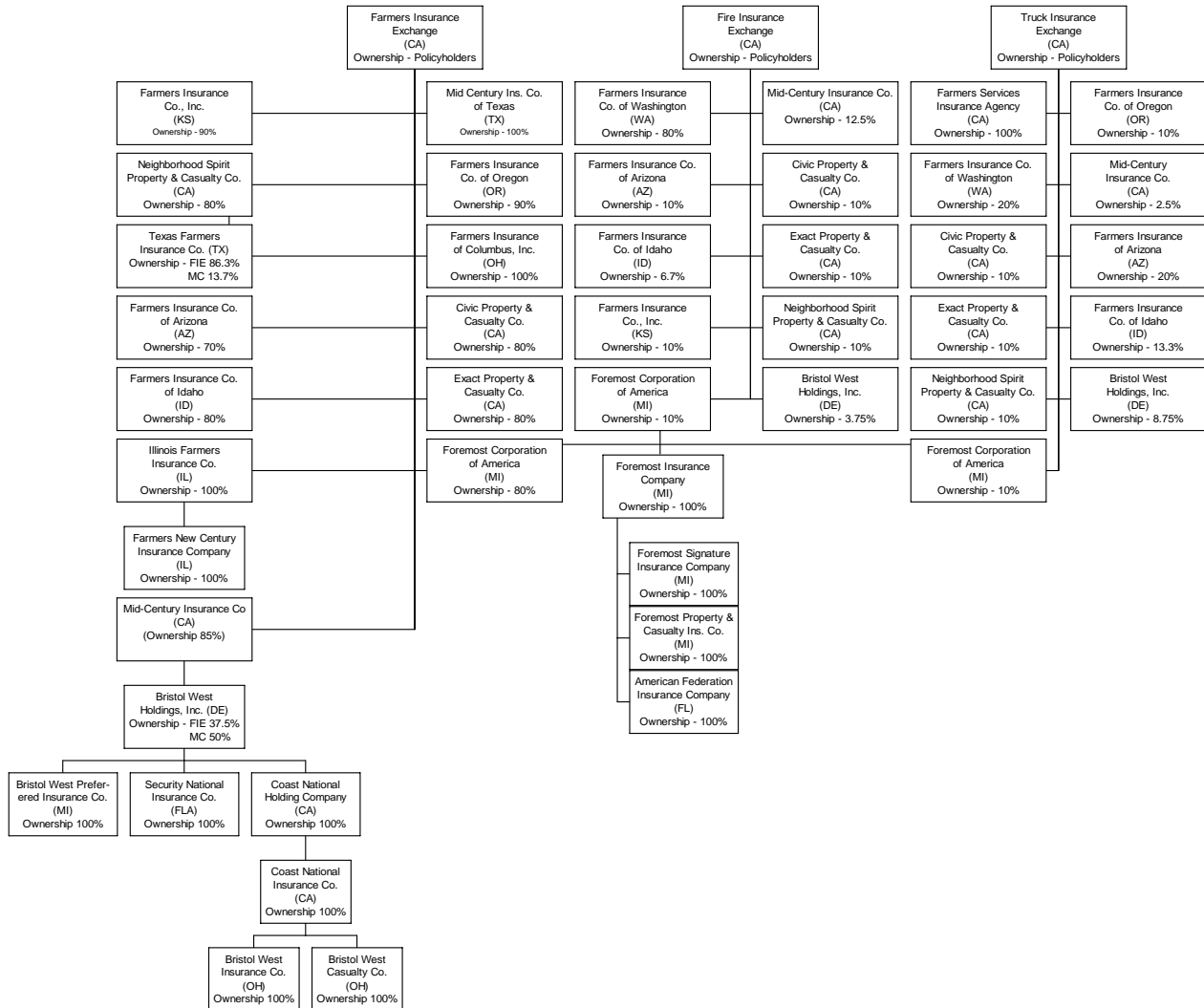


(\*) all ownership is 100% unless otherwise noted.

Note: The Exchange operates directly through Farmers Group, Inc. performing as attorney-in-fact directly, with a dba of Farmers Underwriters Association.

# FARMERS EXCHANGES

DECEMBER 31, 2007



(\*) all ownership is 100% unless otherwise noted.

Management of the Exchange was vested in a twelve (12) member board of governors, elected annually. A listing of the members of the board and principal officers serving on December 31, 2006 follows:

Board of Governors

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
William Haskell Braddock Surprise, Arizona	Retired
Vince Stolte Garrod Saratoga, California	Trustee and Manager Garrod Trust
James Ellwood Hansen Corona, California	Retired
Fredrick Henry Kruse Lake Ozark, Missouri	Banking and Financial Services
Dale Anne Marlin Newport Beach, California	Computer Consultant
Gary Alan McCarter Huntley, Illinois	Retired
Kathleen Leavey McCarthy Los Angeles, California	Trustee Leavey Foundation
Roger Lee Persons Palmdale, California	Owner and Director Chapel of the Valley Mortuary
Donnell Reid Ballwin, Missouri	Retired
Donald Eugene Rodriguez Long Beach, California	Executive Director Boys and Girls Clubs of Long Beach
Taylor Lane Stephens Fort Collins, Colorado	Consultant
Ottie Joel Wallace Merced, California	President Trucking and Logistics Company

## Board of Governors

### Name and Residence

### Principal Business Affiliation

## Principal Officers

### Name

### Title

Paul Norman Hopkins	President and Chief Executive Officer
Ronald Gregory Myhan	Vice President and Treasurer
Doren Eugene Hohl	Secretary
Jason Lawrence Katz	Vice President
Kevin Eugene Kelso	Vice President
Hubert Leslie Mountz	Vice President
Bryan Francis Murphy	Vice President
Mhayse Gokul Samalya	Vice President
Keitha Tullos Schofield	Vice President
Stanley Ray Smith	Vice President
Warren Benjamin Tucker (*)	Vice President
Pierre Christophe Wauthier (**)	Vice President
Frank Robert Woudstra	Vice President

(\*) Resigned on May 31, 2007 and replaced by James Leslie Nutting on June 1, 2007.

(\*\*) Resigned on October 1, 2007 and replaced by Scott Lundquist on February 11, 2008.

## Management Agreements

Farmers Group, Inc. (FGI), the Attorney-In-Fact, provides all operating services (including staffing and occupancy) except claims adjustment services to the Exchange. These services were provided to the Exchange pursuant to the “subscription agreements” signed by each individual policyholder of the Exchange. There was no specific management services agreement required between the Exchange and FGI for the aforementioned services provided. California Insurance Code (CIC) Section 1215.4 and Section 1215.5 provides for an exemption from reporting for an inter-insurance exchange utilizing the subscription agreements providing that the “form of this agreement was in place prior to

1943 and it was not amended in any way to modify payments, fees, or waivers of fees or otherwise substantially amended after 1943”. For 2004, 2005, and 2006, fees paid by the Exchange to FGI for such services were \$803,467,192, \$815,480,872, and \$835,041,327, respectively.

The Exchange is responsible for the payment of claims (adjustment function), payment of commissions and the payment of premium and income taxes.

#### Claims Adjustment Services Arrangement

The Exchange staff a claims department for the adjustment of its own claims and to adjust certain of its affiliated insurance companies’ claims. The claims adjustment services arrangement in place between the Exchange and certain of its affiliates (the pooled companies), with the Exchange providing all of their claims adjustment services, was not written.

#### Managed Care Services Agreement

The Exchange is a party to a managed care services agreement, effective October 1, 1998, with Zurich Services Corporation (ZSC), an affiliate. ZSC provides certain bill review and medical management services for the Exchange’s workers’ compensation claims. It is recommended that the Exchange submit the managed care services agreement to the California Department of Insurance (CDI) pursuant to CIC Section 1215.5 for approval.

### Tax Sharing Agreement

The Exchange's federal income tax return was consolidated with various insurance and non-insurance affiliates and subsidiaries. There was a long-standing written tax sharing agreement in place. The agreement was amended on July 25, 2000 to add Foremost Corporation of America (Foremost) and certain of its subsidiaries, and subsequently amended, effective July 3, 2007, to add Bristol West Holdings, Inc. and all of its subsidiaries, plus two companies owned by Foremost. The tax allocation was based on separate return calculations with current credit for net losses. On January 3, 2008, the CDI approved this latest amended agreement. The Exchange's portion of the federal income taxes paid for 2004, 2005, and 2006, was \$73,593,000, \$82,392,000, and \$94,504,000, respectively.

### Investment Management Agreements

FGI, acting on behalf of the Exchange, Fire Insurance Exchange (Fire), Truck Insurance Exchange (Truck) and the subsidiaries of these three exchanges, entered into an Investment Management Agreement dated July 1, 1998 with its affiliate, Scudder Kemper Investments Inc. (Scudder). In 2002, Scudder was acquired and replaced by Deutsche Asset Management (DeAM), a division of Deutsche Bank, AG. DeAM, a non-affiliate, managed the Exchange, Fire, Truck and the subsidiaries' fixed income and equity asset portfolios. The terms of the Investment Management Agreement have otherwise not been altered.

FGI was also a party to the Service Level Agreement dated November 4, 1998 with Scudder, which was replaced in 2002 by DeAM. DeAM, a non-affiliate, provided accounting and reporting services in connection with the Exchange, Fire, Truck and the stock subsidiaries' investment portfolios, including Securities Valuation Office reporting. DeAM was given the authority to vote the proxies of the common stock. The terms of the Service Level Agreement were left unchanged except for the replacement of parties.



## Securities Lending Agreement

In 1999 the Exchange filed with the CDI a proposed securities lending agreement with an affiliate, Zurich Capital Markets Trust Company (Zurich).

In December 2001, the Exchange changed its securities lending agent from Zurich to the Bank of New York Western Trust (BNY), a non-affiliate, as Zurich had decided to exit the securities lending business. “Collateral” as defined in the securities lending agreement between BNY and the Exchange indicated government securities and cash. The agreement also stipulated that BNY establish a “custodial custody account” in the name of the Exchange for the purpose of holding collateral and approved investments pertaining to securities lending transactions. The custodian was Wall Street Portfolio Advisors, a division of BNY. The current agreement conformed to the securities lending limits specified in CDI Bulletin 82-2.

## TERRITORY AND PLAN OF OPERATION

The Exchange is licensed in the District of Columbia and the following 42 states:

Alabama	Kansas	Nebraska	South Carolina
Arizona	Kentucky	Nevada	South Dakota
Arkansas	Louisiana	New Hampshire	Tennessee
California	Maine	New Jersey	Texas
Colorado	Maryland	New Mexico	Utah
Florida	Massachusetts	North Carolina	Virginia
Georgia	Michigan	North Dakota	Washington
Idaho	Minnesota	Ohio	Wisconsin
Illinois	Mississippi	Oklahoma	Wyoming
Indiana	Missouri	Oregon	
Iowa	Montana	Rhode Island	

### Major Lines of Business:

The Exchange, and its pooled subsidiaries and affiliates, write most of the property and casualty lines of business with a heavy emphasis on personal lines. The principal lines written or assumed by the Exchange (the lead pooling company in the pooling arrangement) were private passenger auto liability, auto physical damage, and homeowners multiple peril. By volume, commercial multiple peril, and to a lesser extent, workers' compensation writings were the more material commercial lines being written.

In 2006, the Exchange wrote \$3.8 billion of direct premiums. Of the direct premiums written, \$1.8 billion (47.4%) was written in California, \$327.5 million (8.6%) was written in Texas, \$284.3 million (7.5%) was written in Colorado and \$1.4 Billion (36.5%) was written in the remaining states.

Personal and commercial business is produced for the Exchange and affiliated property and casualty companies by an exclusive agency force of more than 18,000 agents and was supported by 30 state executive offices, 12 personal and commercial service centers, and 150 branch claim offices.

Approximately one-half of the property and casualty companies' business continues to be concentrated within the states of California and Texas. However, in recent years, the Farmers property and casualty companies have been expanding market presence eastward.

The Farmers property and casualty companies announced, during the fall of 2003, that they were fully withdrawing from the writing of the Medical Malpractice line of business. Policies then-existing were runoff.

The Exchange operates directly through Farmers Group, Inc., which functions as the attorney-in-fact with a dba of Farmers Underwriters Association. Fire Insurance Exchange and Truck Insurance Exchange also operates through Farmers Group, Inc. under separate dba's: Fire Underwriters Association, and Truck Underwriters Association, respectively.

## REINSURANCE

### Intercompany Reinsurance Pooling Agreement

The Exchange, and certain other property and casualty companies, participated in an intercompany reinsurance pooling agreement. Under this agreement, the affiliated participants ceded all of their business, net of all reinsurance, to the Exchange (the lead company). The Exchange then retroceded a share of the business back to certain participants based on percentages prescribed under the pooling agreement. The most recent amendment to this long-standing agreement was approved by the California Department of Insurance (CDI) on January 12, 1999.

The participants in the intercompany reinsurance pooling agreement, and their respective participation percentages as of December 31, 2006, were as follows:

<u>Pool Participant</u>	<u>Percentage</u>
Farmers Insurance Exchange	51.75
Truck Insurance Exchange	7.75
Fire Insurance Exchange	7.50
Farmers Insurance Company of Oregon	7.00
Farmers Insurance Company of Washington	2.00
Mid-Century Insurance Company	16.00
Texas Farmers Insurance Company	1.00
Farmers Insurance Company, Inc.	0.75
Illinois Farmers Insurance Company	0.75
Farmers New Century Insurance Company	0.75
Farmers Insurance Company of Idaho	0.75
Farmers Insurance of Columbus, Inc.	1.00
Civic Property and Casualty Company	1.00
Exact Property and Casualty Company	1.00
Neighborhood Spirit Property and Casualty Company	<u>1.00</u>
Total	<u>100.00</u>

### Assumed

Pursuant to long-standing 100% quota share reinsurance agreements, the Exchange also assumed business from certain members of the affiliated property and casualty companies which did not participate in the inter-company reinsurance pooling program as follows: Farmers Insurance Company of Arizona (1970); Mid-Century Insurance Company of Texas (1987); Farmers Texas County Mutual Insurance Company (1993); Maryland Casualty Company (1999); and Foremost Insurance Company Grand Rapids, Michigan (Foremost I.C.) (2000). As a result of the inter-company reinsurance pooling agreement and the reinsurance assumed agreements, the Exchange assumed 100% of the business written by all members of the Farmers Group Companies.

Effective January 1, 2000, via a quota share agreement, the Exchange assumed 100% of Foremost I.C.'s in-force business as of that effective date and 100% of renewal and new business after the effective date. This agreement was approved by the CDI on August 10, 2000.

Subsequently, effective January 1, 2007, via a quota share agreement the Exchange began assuming 90% of Coast National Insurance Company's business. The CDI approved this agreement on June 29, 2007.

### Ceded

### Affiliated

The Exchange maintained fronting arrangements (the so-called "RAS" treaties, which were historically long-standing reinsurance agreements with affiliates initiated between 1950 and 1995) by which all of the property business it wrote was ceded "prior to the inter-company pooling" to Fire Insurance Exchange. Similarly, all of its workers' compensation, medical malpractice, and commercial lines business was ceded to Truck Insurance Exchange via the RAS agreements.

Other affiliated reinsurance cessions that the Exchange engaged in included an auto physical damage (APD agreement) 100% quota share agreement with several participants, including the affiliated Zurich Insurance Company (Zurich) with an initial 65% participation and the affiliated Farmers Reinsurance Company (Farmers Re) with a 10% participation. Several non-affiliated reinsurers assumed the remaining 25% in participation. The premium for this APD agreement since 2001 was \$2 billion annually. The APD agreement was approved by the CDI in 2001 for one year, with one-year extensions granted in 2002 and 2003. In 2004, the APD agreement was revised to reduce the quota share percentage to 50%, with Zurich assuming a 40% participation and Farmers Re assuming the remaining 10% participation. Effective January 1, 2006 the above amended APD agreement was replaced by a new APD 100% quota share agreement. The premium for this replacement APD agreement was \$1 billion annually with Zurich assuming an 80% participation and Farmers Re assuming a 20% participation. The CDI approved this agreement on December 28, 2005.

On December 31, 2002, the Exchange and its property and casualty subsidiaries and affiliated exchanges entered into a 10% “all-lines” quota share reinsurance agreement ceding business to Zurich and Farmers Re. This agreement covered all lines directly written, assumed from affiliates, or assumed from pools, associations, or syndicates. This agreement was then amended, effective December 31, 2004, to increase the percentage to 12% and amended again effective December 31, 2005, to decrease the percentage down to 6% (Zurich 4.8% participation and Farmers Re 1.2% participation), which was the cession at the examination date. The CDI approved this 2005 amendment on December 28, 2005. Subsequently, the agreement was amended effective December 31, 2007 to decrease the percentage to 5% (Zurich 4% participation and Farmers Re 1% participation) and extend the duration to December 31, 2010. This latest amendment was approved by the CDI on December 28, 2007.

Effective January 1, 2000, the Exchange entered into a Retrocession Agreement with Foremost I.C. through which the Exchange retroceded to Foremost I.C. 95% of mobile home, manufactured homes and recreational vehicle business concurrently ceded by Foremost I.C. under the reinsurance agreement. The Exchange retained business (assumed from Foremost I.C.) other than insurance on

mobile homes, manufactured homes and recreational vehicles. The CDI approved this agreement on August 10, 2000.

### Non-affiliated

Treaties ceding risks to non-affiliated reinsurers were written with the Exchange and all of its subsidiaries and affiliates as the cedents. The following is a summary of the principal non-affiliated ceded excess of loss reinsurance treaties in force as of December 31, 2006:

Type of Contract	Reinsurer's Name	Company's Retention	Reinsurer's Maximum Limits
Property Catastrophe Excess of Loss – 1 <sup>st</sup> Layer	Lloyds of London (26.62%) Various reinsurers (63.38%)	\$200 million per occurrence	90% of \$450 million excess of \$200 million retention each and every loss occurrence. Terrorism excluded.
Property Catastrophe Excess of Loss – 2 <sup>nd</sup> Layer	Various reinsurers (90%)	\$650 million per occurrence	90% of \$300 million excess of \$650 million retention each and every loss occurrence. Terrorism excluded. For Texas only, this layer is in excess of the \$500 million excess of \$650 million layer immediately below.
Property Catastrophe Excess of Loss – Texas	Lloyds of London (22.93%) Various reinsurers (76.07%)	\$650 million per occurrence	99% of \$500 million excess of \$650 million, Texas only. Terrorism excluded (Property CAT Excess of Loss treaty above covers resulting loss corridor – resulting in Company net retention of \$200 million.).
Multi-Event Property Catastrophe Excess of Loss	Lloyds of London (32.74%) Various reinsurers (57.26%)	\$20 million per event plus a \$360 million aggregate deductible	90% of \$180 million excess of \$20 million. Excludes California earthquake, Florida hurricane, mold, and terrorism.
Property Per Risk Excess of Loss – 1 <sup>st</sup> Layer	Lloyds of London (48.28%) Various reinsurers (51.72%)	\$3 million each and every loss, any one risk	100% of \$7 million excess of \$3 million each and every loss, any one risk
Property Per Risk Excess	Lloyds of London	\$10 million each and	100% of \$40 million excess of

<b>Type of Contract</b>	<b>Reinsurer's Name</b>	<b>Company's Retention</b>	<b>Reinsurer's Maximum Limits</b>
of Loss – 2nd Layer	(46.88%) Various reinsurers (53.12%)	every loss, any one risk	\$10 million each and every loss, any one risk
Casualty/Workers' Comp. Excess of Loss – 1 <sup>st</sup> Layer	Lloyds of London (37%)  Endurance Specialty Ins. Ltd. (25%)  Aspen Insurance UK Limited (25%)  Various reinsurers (13%)	\$10 million each occurrence	100% of \$15 million excess of \$10 million each occurrence.
Casualty/Workers' Comp. Excess of Loss – 2nd Layer	Lloyds of London (47%)  Endurance Specialty Ins. Ltd. (25%)  Aspen Insurance UK Limited (17%)  Various reinsurers (11%)	\$25 million each occurrence	100% of \$25 million excess of \$25 million each occurrence.
Casualty/Workers' Comp. Excess of Loss – 3 <sup>rd</sup> Layer	Lloyds of London (18.5%)  Endurance Specialty Ins. Ltd. (25%)  Aspen Insurance UK Limited (20%)  Various reinsurers (6.5%)	\$50 million each occurrence, plus 30% of \$50 million excess	70% of \$50 million excess of \$50 million each occurrence.  For Workers' Comp. portion only an additional 30% is covered under the following CAT XOL treaty.
Workers' Compensation Catastrophic Excess of Loss	AXA RE (20%) Flagstone Reinsurance Limited (10%)	\$50 million each occurrence	30% of \$50 million excess of \$50 million each occurrence

As of December 31, 2006, reinsurance recoverables for all ceded reinsurance totaled \$11.3 billion or 358% of surplus as regards policyholders. Of the reinsurance recoverables 92% were from admitted affiliates, primarily resulting from the pooling arrangement of which the Exchange was the lead company, and 7.2% of the reinsurance recoverables were from Zurich, a non-admitted affiliate.

## FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2006

Underwriting and Investment Exhibit for the Year Ended December 31, 2006

Reconciliation of Surplus as Regards Policyholders  
from December 31, 2003 through December 31, 2006



Statement of Financial Condition  
as of December 31, 2006

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Note</u>
Bonds	\$ 5,822,650,660	\$	\$ 5,822,650,660	
Stocks:				
Preferred stocks	1,154,793		1,154,793	
Common stocks	2,761,378,869		2,761,378,869	
Real estate:				
Properties occupied by the company	34,039,848		34,039,848	
Properties held for production of income	791,804		791,804	
Cash and short-term investments	373,523,650		373,523,650	
Other invested assets	10,983,255		10,983,255	
Aggregate write-ins for invested assets	286,134,458		286,134,458	
Investment income due and accrued	58,733,545	1,750	58,731,795	
Premiums and considerations:				
Uncollected premiums and agents' balances in the course of collection	451,710,518	51,827,523	399,882,995	
Deferred premiums, agents' balances and booked but deferred and not yet due	1,111,126,127		1,111,126,127	
Accrued retrospective premiums	3,810,312		3,810,312	
Amounts recoverable from reinsurers	468,443,664		468,443,664	
Net deferred tax asset	264,255,950		264,255,950	
Guaranty funds receivable or on deposit	7,627,298		7,627,298	
Electronic data processing equipment	634,341		634,341	
Furniture and equipment	2,044,011	2,044,011		
Receivables from parent, subsidiaries and affiliates	303,589,790		303,589,790	
Aggregate write-ins for other than invested assets	<u>12,632,846</u>	<u>2,285,306</u>	<u>10,347,540</u>	
Total assets	<u>\$11,975,265,739</u>	<u>\$ 56,158,590</u>	<u>\$11,919,107,149</u>	

Liabilities, Surplus and Other Funds

Losses	\$ 2,873,253,226	(1)
Reinsurance payable on paid losses and loss adjustment expenses	667,542,443	
Loss adjustment expenses	829,132,440	(1)
Commissions payable, contingent commissions and other similar charges	2,320,558	
Other expenses	378,735	
Taxes, licenses and fees	5,379,576	
Current federal and foreign income taxes	73,115,962	
Unearned premiums	2,394,863,306	
Advance premium	57,515,707	
Dividends declared and unpaid: Policyholders	1,552,499	
Ceded reinsurance premiums payable	552,408,594	
Funds held by company under reinsurance treaties	833,444,567	

Amounts withheld or retained by company for account of others	8,888,149
Remittances and items not allocated	92,878,458
Provision for reinsurance	952,321
Payable for securities	84,474
Aggregate write-ins for liabilities	<u>376,829,070</u>
Total liabilities	8,770,540,085
Surplus notes	\$1,460,480,000
Unassigned funds (surplus)	<u>1,688,087,064</u>
Surplus as regards policyholders	<u>3,148,567,064</u>
Total liabilities, surplus and other funds	<u>\$11,919,107,149</u>

Underwriting and Investment Exhibit  
for the Year Ended December 31, 2006

Statement of Income

Underwriting Income

Premiums earned		\$ 5,894,713,241
Deductions:		
Losses incurred	\$ 3,278,871,038	
Loss expenses incurred	677,150,147	
Other underwriting expenses incurred	1,706,394,296	
Aggregate write-ins for underwriting deductions	13	
Total underwriting deductions		<u>5,662,415,494</u>
Net underwriting gain		232,297,747

Investment Income

Net investment income earned	\$ 177,828,949	
Net realized capital gains	<u>8,793,622</u>	
Net investment gain		186,622,571

Other Income

Net loss from agents' or premium balances charged off	\$ (36,535,385)	
Finance and service charges not included in premiums	13,370,321	
Aggregate write-ins for miscellaneous income	<u>(52,828,253)</u>	
Total other income		<u>(75,993,317)</u>
Net income before dividends to policyholders, after capital gains tax and before all other federal and foreign income taxes		342,927,001
Dividends to policyholders		2,692,734
Federal and foreign income taxes incurred		<u>95,491,673</u>
Net income		<u>\$ 244,742,594</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2005		\$ 2,721,024,752
Net income	\$ 244,742,594	
Change in net unrealized capital gains	284,924,193	
Change in net deferred income tax	22,959,689	
Change in nonadmitted assets	(13,106,555)	
Change in provision for reinsurance	1,011,208	
Change in surplus notes	(106,935,000)	

Aggregate write-ins for gains and losses in surplus	<u>(6,053,817)</u>	
Change in surplus as regards policyholders		<u>427,542,312</u>
Surplus as regards policyholders, December 31, 2006		<u>\$ 3,148,567,064</u>

Reconciliation of Surplus as Regards Policyholders  
from December 31, 2003 through December 31, 2006

Surplus as regards policyholders, December 31, 2003, per Examination			\$1,400,049,255
	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>	
Net income	\$ 913,084,371	\$	
Change in net unrealized capital gains	723,173,098		
Change in net deferred income tax	101,450,012		
Change in nonadmitted assets	128,788,095		
Change in provision for reinsurance		73,961	
Change in surplus notes		107,520,000	
Aggregate write-ins for losses in surplus	<u>                    </u>	<u>10,383,806</u>	
Totals	<u>\$1,866,495,576</u>	<u>\$117,977,767</u>	
Net change in surplus as regards policyholders for the examination			<u>1,748,517,809</u>
Surplus as regards policyholders, December 31, 2006, per Examination			<u>\$3,148,567,064</u>

## COMMENTS ON FINANCIAL STATEMENT ITEMS

### (1) Losses and Loss Adjustment Expenses

The Exchange was directed by the California Department of Insurance (CDI), under California Insurance Code Section 733(g), to retain the American Actuarial Consulting Group, LLC, (AACG) for the purpose of assisting this examination in determining the reasonableness of the Exchange's loss and loss adjustment expense reserves. Because the business of the Farmers property and casualty companies was pooled, it was necessary to review the losses on a group-wide basis. Based on the analysis by AACG and the review of their work by a Casualty Actuary from the CDI, the Exchange's December 31, 2006 reserves for losses and loss adjustment expenses were determined to be reasonably stated and have been accepted for purposes of this examination.

## SUMMARY OF COMMENTS AND RECOMMENDATIONS

### Current Report of Examination

Management and Control - Managed Care Services Agreement (Page 13): Zurich Services Corporation (ZSC), an affiliate, provided certain bill review and medical management services for the Exchange's workers' compensation claims. It is recommended that the Exchange submit the managed care services agreement to CDI for approval pursuant to CIC Section 1215.5.

### Previous Report of Examination

Contingent Liabilities (Page 3): Based on discussions with Exchange's attorneys (and the limited review of public domain documents obtained), the examiners were able to obtain an understanding of the volume and range of "class action either claims-related or non-claims-related" lawsuits that the Farmers property and casualty group appeared to be exposed to. However, due to the constraints evident in the Exchange limiting the examiners' access only to "public domain" documents or

attorney discussion, a sufficiently complete understanding of the Exchange's contingent liability exposure was not practical or accomplished. The current examination's review of legal data/documents was limited to "public-domain" only, similar to that of the previous examination.

Common Stocks (Page 26): The carrying value of the common stock of certain pooled subsidiaries of the Exchange was reduced by their participation in the higher level of loss and loss adjustment expense reserves determined on a group-wide basis by the CDI actuaries, and for their pooled share of the accrual of liabilities for the Bell and MDL cases. These reductions in the carrying value of common stocks owned by the Exchange totaled \$364,906,655. The December 31, 2006, carrying values of common stocks in pooled subsidiaries owned by the Exchange were accepted as reasonable for the current examination.

Federal and Foreign Income Tax Recoverable (Page 27): The examination increased the amount of federal income tax recoverable by \$186,931,799. This was the result of accruing for the tax effect of the higher level of net loss and loss adjustment expense reserves, and the accrual of the Bell and MDL cases, as recorded in the prior examination report. This tax effect amount appeared to qualify for treatment as a Net Operating Loss (NOL) carry back. The amount reported by the Exchange for Federal and Foreign Income Tax Recoverables was accepted as reasonable for this examination.

Losses and Loss Adjustment Expenses (Page 27): Based upon an independent actuarial review, the Exchange's net loss and loss adjustment expense reserves as of December 31, 2003 were determined to be \$469,374,000 deficient and were adjusted for purposes of the examination. Current carried net loss and loss adjustment expense reserves appeared adequate.

Aggregate Write-Ins for Liabilities (Page 28): The amount of "aggregate write-ins for liabilities" per the prior examination was \$101,844,338 greater than the Exchange stated amount. The current balance carried in aggregate write-ins for liabilities was accepted as reasonable.

## ACKNOWLEDGEMENT

The courtesy and cooperation extended by the Exchange's officers and employees during the course of this examination are hereby acknowledged.

Respectfully submitted,

/S/

Gary W. McMurray, CFE  
Examiner-In-Charge  
Contract Insurance Examiner  
Department of Insurance